Dominion Virginia Power
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Dominion
Virginia Power

May 5, 2005

Dear Mr. Eichenlaub,

Dominion Virginia Power ("Dominion" or "the Company") is pleased to submit our annual comments on the status of electric industry restructuring and competition in the Commonwealth. We hope these comments will be useful to the Staff and to the Commission as you compile your annual report.

While increased market prices during a period of capped rates work against the development of retail competition in Virginia, we strongly believe that the Commonwealth's effort to restructure the electric utility industry is making significant long-term progress. In the short term, the effort is producing substantial savings for Virginia consumers and is contributing to the economic growth in the Commonwealth.

Dominion Integration into PJM

One of the clearest hallmarks of this development was Dominion's May 1 integration into the PJM Interconnection, LLC. At midnight on that date Dominion turned over operational control of its 6,000 miles of transmission lines to PJM, the largest regional transmission organization (RTO) in the United States. PJM will operate Dominion's transmission assets as the PJM South region. PJM manages more than 50,000 miles of transmission lines stretching from Illinois to North Carolina with the integration of Dominion. The PJM service area contains about 168,000 megawatts of installed generating capacity.

The development of RTOs, called regional transmission entities (RTE) in the Virginia Electric Utility Restructuring Act (Restructuring Act), was viewed as a foundation of the Commonwealth's restructuring process by the framers of the law. Section 56-579 of the Act directs all Virginia utilities "owning, operating, controlling or having entitlement to transmission" to "join or establish" a RTO. The commitment to regional transmission was affirmed by the 2003 General Assembly through the passage of House Bill 2453 amending the Act. Dominion's PJM membership was approved by the State Corporation Commission on November 10, 2004, by the Federal Energy Regulatory Commission on October 5, 2004, and by the North Carolina Public Utilities Commission on April 19, 2005.

Integration into PJM will produce significant benefits for the Commonwealth and its consumers. PJM's ability to monitor and control transmission assets across a broad region of the country will enhance system reliability. PJM's ability to respond quickly and effectively to changing grid conditions has been hailed as a key factor in stemming the cascading blackout that affected much of the northeastern United States and Canada in August 2003. PJM's regional planning expertise will enhance reliability by directing improvements across a wide area. Dominion's integration into PJM will also give the

Commonwealth's consumers improved access to a diverse supply of generation, another important step in ensuring relability.

Additionally, Dominion's participation in PJM will promote the development of wholesale and retail competition for the supply of electricity. PJM promotes wholesale competition by eliminating market barriers posed by multiple transmission rates – so-called rate "pancaking." PJM will also give competitive service providers (CSPs) in Virginia increased access to competitively priced generation.

In fact, stakeholders have almost universally viewed the lack of a functioning RTO in Virginia as a prime impediment to competition. The Commission took note of this view in its 2003 report on the status of competition in Virginia:

"Perhaps the most common issue raised among the comments submitted in response to the Staff's letter regards the lack of a fully functional RTO as the major obstacle to active competition."

With Dominion's integration, all utilities covered by the RTE membership requirements of Section 56-579 of the Restructuring Act are now included in PJM, operator of the world's largest competitive wholesale electricity market. The integration into PJM will make the extensive and diverse generating capacity within this market more available to meet the needs of Virginia customers, including those receiving default service after capped rates end on December 31, 2010. Access to this successful and highly competitive market will help fulfill the Restructuring Act's mandate, expressed in Section 56-585.C.1, that "after the expiration or termination of such capped rates, the rates for default services shall be based upon competitive market prices for electric generation services."

Restructuring Already Producing Significant Consumer Benefits

The Commonwealth's restructuring process is already producing substantial savings for Virginia consumers. These savings are even more striking against a backdrop of sharply rising prices for almost all other forms of energy, as well as steep electricity price increases in many other states.

The Restructuring Act has produced these savings through curbs on both base and fuel rates for electricity. Senate Bill 651 (SB 651), passed by the 2004 General Assembly, amended the Restructuring Act and froze the provisions of Dominion's fuel factor through July 1, 2007. At that point, the Commission will adjust the fuel rate, based on estimated fuel costs, to run through the end of the capped rate period on December 31, 2010. SB 651 extended the capped rates, originally scheduled to terminate on July 1, 2007, by three and one-half years.

Savings from the fuel factor freeze have been striking. In 2004, the Company reported a fuel under-recovery in Virginia of approximately $201 million. The Company has publicly stated that it expects a similar under-recovery in 2005. It is difficult to quantify exactly how much the fuel factor would have risen in the absence of the freeze. However, the Company earlier this year estimated the adjusted fuel rate would have increased the typical 1,000 kWh residential bill by approximately 8 percent.

The fuel factor freeze was implemented as energy sector market prices rose to record levels. From September 2003 to December 2004, market commodity prices for coal rose by 83 percent, oil by 54 percent, and natural gas by 36 percent, according to the U.S. Department of Energy's Energy Information Administration (EIA). In addition, during the past year, retail gasoline prices in the mid-Atlantic region have increased by more than 42 percent, according to the EIA.

Savings from Capped Base Rates

Potential savings from capped base rates are expected to be even more dramatic. The Restructuring Act capped Dominion's base electric rates at early-1990s levels. Capped rates represented a significant shift of risk from utility customers to shareholders and brought to a halt the base rate cases that frequently occurred on an almost-annual basis. Adjusted for inflation, Dominion's base rates are expected to be about 40 percent lower in 2010, the end of the capped rate period, than in 1994.

In January 2004, a Dominion-commissioned study by Chmura Economics & Analytics found that capped base rates would save the Company's Virginia residential customers as much as $1.8 billion through 2010. This translates into per-customer savings of up to $966 during the extended transition period, according to the study. It also forecast that capped base rates would generate about $307 million in additional economic activity in the Commonwealth.

The Restructuring Act has imposed base rate stability during a period of rising costs for utilities. According to the U.S. Department of Labor's Producer Price Index, the price of copper rose by almost 129 percent from December 2001 to March 2005. During the same period, iron and steel increased by about 63 percent; electric wire and cable by more than 16 percent; and transformers and power regulators by about 12 percent.

Virginia's Rate Stability: A Sharp Contrast with Other States

Virginia's rate stability also stands in sharp contrast to the behavior of electric rates in states that have not embarked on restructuring. Since January 1, 2003, utilities in more than two dozen states maintaining traditional cost-of-service regulation have petitioned for or implemented rate increases, often of double-digit magnitude.

The rising rates have been most pronounced in Florida. Florida Power and Light's typical monthly bill for a 1,000 kWh residential customer has risen by 32 percent, from $69.73 in 2000 to $92.01 this year, according to information on the company's web site. Factors specific to Florida have driven many of the increases in the state, such as heavy dependence on natural gas-fired generation and hurricane recovery costs. However, rates have risen sharply in states that do not face these problems.

Georgia Power, for example, in February asked the state's Public Service Commission for a $550 million increase in the company's fuel cost recovery. If approved, the increase would raise the average residential customer's monthly bill by approximately 10 percent, according to the February 17 edition of the *Atlanta Journal-Constitution*. The petition for the higher fuel rate follows a $134 million base rate increase, approved by the Public Service Commission in December 2004. This increase raised the average monthly residential bill by approximately 4 percent. Also in Georgia, Savannah Electric and Power Company has requested a base rate increase that would raise the typical monthly residential bill by about 8.8 percent, according to a company news release. The petition is now before the Public Service Commission.

In Kentucky, the Public Service Commission in June 2004 approved base rate increases for both Louisville Gas & Electric Co. (LG&E) and Kentucky Utilities Co. (KU). The increases raised LG&E's average monthly residential bill by 8.9 percent and KU's by 6.4 percent, according to a Public Service Commission news release.

Wisconsin has also seen an upward spiral of electric rates, affecting virtually every part of the state. Some utilities have applied for – and been granted – multiple rate increases. The adjustments have raised both base and fuel rates, occasionally by double-digit figures. As an example in Wisconsin, Wisconsin Public Service Co. (WPS) just this month applied for an 11.4 percent base rate increase and We Energies recently applied for a $115 million fuel rate increase. If approved, this would raise the average monthly residential bill by about 4.8 percent, according to the company. Further the company warned customers to expect rate increases averaging 3 to 4 percent annually during the next few years.

These increases, and those in many other states maintaining traditional regulation, bear out the warning made by the respected trade publication *Public Utilities Fortnightly* in April 2004. *Public Utilities Fortnightly* warned of impending "sticker shock" due to utilities petitioning state utility commissions for the rate basing of billions of dollars of improvements, including new generation and environmental upgrades. (Richard Stavros, "Sticker Shock," *Public Utilities Fortnightly*, April 2004, pages 4-5)

Since that article appeared, soaring fuel prices have exacerbated pressure to raise rates. But the Restructuring Act continues to protect Dominion's retail customers in Virginia from these factors.

Promotion of Energy Reliability for the Commonwealth

The Restructuring Act, particularly the 2004 amendments incorporated in SB651, is also working to promote a high level of continued energy reliability in the Commonwealth. Section 56-585.G of the Restructuring Act, added in 2004, encourages development of a coal-fired generating station to serve Virginia utilities' native load and default service customers. The station would utilize Virginia coal and promote the economic development of the Commonwealth's coal-producing regions. On February 24, Virginia's leading electric utilities announced formation of a consortium to explore the development of the facility in Southwest Virginia. Consortium participants include Dominion, Appalachian Power, Old Dominion Electric Cooperative, the Virginia Municipal Electric Association, and the Blue Ridge Power Agency. The non-binding agreement is an expression of the utilities' interest in exploring the development of the project and does not commit them to participating in construction or operation. Dominion will undertake, on behalf of the consortium, the initial development activities for the station, which is expected to cost approximately $1 billion. The possible timeline announced in February included a construction start in 2008 and commercial operation in 2012.

Retail Competition Development in Virginia

The sharp upward movement in energy market prices, including wholesale prices for electricity, has slowed the development of retail competition in Virginia. Market prices were so high, in fact, that Dominion determined most of its customer classes would incur no wires charges during 2005. After making this determination, Dominion waived its right to collect wires charges from any customer classes this year, while reserving the right to impose them in the future.

Even in the absence of wires charges, CSPs have found it virtually impossible to make competitive offers that undercut the capped rates. This situation has also worked against Dominion's retail pilots, despite the Company's efforts to revise them. However, if market prices should decline, the Company believes the changes made in the pilot programs during the past year will make it easier for CSPs to make attractive offers to customers.

For example, the Company has dropped the monthly bidding cycle from its Competitive Bid Supply (CBS) pilot. Instead, CSPs may now submit bids on any business day; this change enables them to move quickly when market prices become favorable. If a CSP submits an offer, other CSPs would have the opportunity to submit competing bids the next business day and the original CSP would have a chance to refresh its offer. The Company also modified the bidding period for the CBS pilot. Under the revisions, there will be one bidding period, extending through October 2007, instead of the two initially proposed. The Commission approved these revisions to the CBS pilot in March 2005.

Interestingly, up until early 2004, only three CSPs had completed licensing to do business in the Commonwealth and had registered with Dominion Virginia Power. Currently, there are six suppliers that are licensed in Virginia and registered with Dominion Virginia Power, with an additional five that are licensed to do business in the Commonwealth but have not completed registration with the Company. Three other suppliers have shown significant interest in restructuring in the Commonwealth and have filed comments in several applicable regulatory proceedings before the Virginia State Corporation Commission. In terms of aggregators interested in opportunities in Virginia, currently there are five entities that have completed both the licensing and registration processes. An additional seven companies are licensed to do business but have not completed the registration process. Clearly, suppliers and aggregators are monitoring progress in the Commonwealth, and are getting ready to move when market conditions are more favorable.

The Company has actively pursued its municipal aggregation and commercial and industrial pilots. Here again, high market prices have proved a barrier to any competitive activity. Dominion, however, has worked with several cities and counties considering participation in the municipal aggregation pilot. During 2004, the Company commissioned a study of the feasibility of six interested municipalities participating in the program. The local governments selected Buckeye Energy Brokers, Inc., an Ohio firm with wide experience in municipal aggregation, to conduct the study. In its report, Buckeye Energy Brokers found it was "very likely" participating municipalities could reach agreements with competitive suppliers that would save money for consumers. The report also termed the pilot "an excellent program...that appears feasible to implement." (Page 1 of the Executive Summary)

Dominion has actively supported the Commission's efforts to implement the wires charge and minimum stay exemption programs authorized by SB 651. We submitted our compliance filing for the two programs on January 10, 2005. The Company's proposed wires charge exemption program included a provision allowing participants who enrolled with a CSP during 2005 to return to capped rate service after their October 2007 meter reading date. This provision was designed to address customer and supplier concerns that the risk of waiving the right to capped rates forever outweighed the benefits of participating. We urge the Commission to complete action on the implementation of the SB 651 programs as soon as possible, as the Restructuring Act calls for the expiration of all wires charges in little more than two years – on July 1, 2007. Without such implementation in the near term, the opportunity for success of the wires charge exemption program will quickly disappear.

A decline in market prices would make successful offers from CSPs much more likely, especially since competitors now have improved access to generation supplies through Dominion's PJM membership.

In conclusion, the implementation of restructuring continues to make substantial progress in the Commonwealth. All incumbent utilities, subject to the RTE provision of the Restructuring Act have now joined PJM. This fulfills a core requirement of the Act and enhances reliability while providing access to a robust wholesale market. Consumers are seeing significant benefits through the capped rates and the frozen fuel factor in a period when prevailing costs that would have driven rates upward under traditional ratemaking are rising significantly. Another consequence of the stability provided by these capped base rates and frozen fuel factor, however, is that it will be very difficult for CSPs to make attractive offers of savings to customers if prevailing wholesale market prices remain elevated. As a result, the number of customers that switch to a CSP can be reasonably expected to remain at relatively low levels during the capped rate period. The number of customers that have switched to a CSP should not be used to measure the success of electric restructuring in Virginia or elsewhere. This expected state of affairs also should not be misconstrued as a failure of restructuring in Virginia, but given the constructs of the Restructuring Act, viewed positively as a reasonable and acceptable position at this stage of the transition toward a fully restructured electric industry in the Commonwealth.

If we can be of further assistance as you develop your annual report, please let us know.

Sincerely,

E. Paul Hilton

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